A Climate of Change

ESG Investing: Pushing the Boundaries from *Optional* to Essential

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Today, there is an increasing focus on the non-financial aspects of investing. Investing with sustainability or social responsibility in mind is often referred to as Environmental, Social, and Corporate Governance ("ESG"). ESG is an increasingly popular concept in the financial industry without precise definitions of its three main aspects. However, as our understanding and awareness of it and its metrics continue to grow, some descriptions have begun to emerge (see Figure 1).

Defining ESG The Financial Times Lexicon explains that "ESG factors are a subset of non-financial performance indicators which include sustainable, ethical and corporate governance issues such as managing the company's carbon footprint and ensuring there are systems in place to ensure accountability." Further, ESG can be broken down into nine areas as identified by the European Federation of Financial Analysts Societies (EFFAS):

1) Energy efficiency
2) Greenhouse gas (GHG) emissions
3) Staff turnover
4) Training & qualification
5) Maturity of workforce
6) Absenteeism rate
7) Litigation risks
8) Corruption
9) Revenues from new products

Source: The Financial Times Lexicon "Definition of ESG" **Figure 1.**

Private equity is one area of the financial ecosystem that has been sharpening its focus on ESG, with its incorporation becoming "more commonplace in the formal RFP processes" according to a recent Greenwich Associates study of 322 global investors. Based on this study, even 73 percent of the investors that do not currently employ ESG principles are thinking about adding this to their investment strategy. [1]

This shift in investment strategy is likely to expand as investors become more aware of the connection between effective ESG investment goals and higher rate of returns. In "Environmental, Social, and Governance Key Performance Indicators from a Capital Market Perspective," Bassen and Kovács portray ESG performance "as a proxy for management quality, in so far as it reflects the company's ability to respond to long-term trends and maintain a competitive advantage."[2] Using these premises of ESG performance as a long-term management proxy and its correlation with greater returns, wise ESG investment decisions are likely to ultimately deliver the greatest returns over the long term.

[1] https://www.greenwich.com/esg-investing-global-phenomenon-report-download

[2] Bassen, A., & Kovács, A. M. (2008). Environmental, social and governance key performance indicators from a capital market perspective. Zeitschrift für Wirtschafts- und Unternehmensethik, 9(2), 182-192. https://nbn-resolving.org/ urn:nbn:de:0168-ssoar-348863

Increasing Allocations

According to the 2016 Global Sustainable Investment Review (GSI)[3], there was $22.89 trillion USD in global "assets being professionally managed under responsible investment strategies, an increase of 25 percent since 2014." Pensions & Investments news and research center highlighted a 16.9 percent increase for the same period among institutional investors in the U.S.[4] (see Figure 2).

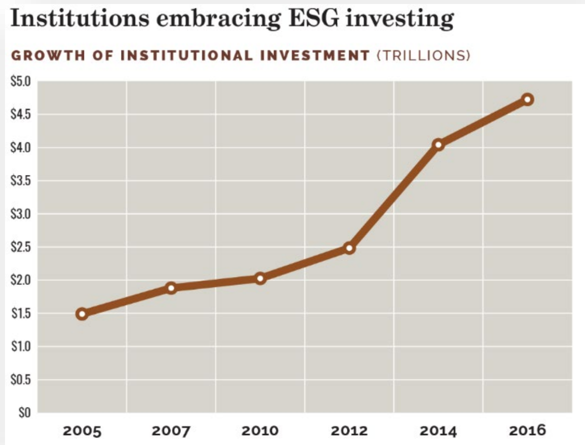

Figure 2 – source: Pensions & Investments

PIMCO explains the increased allocations with key themes they identified in "10 Reasons ESG Investing is Growing" which includes:

- Good governance is systemically important
- Climate change is a reality
- Changing energy sources change energy markets
- Social media drives converging social norms which affect preferences
- Global value chains elevate issues such as child labour practices or environmental impact[5]

[3] http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf
[4] https://www.pionline.com/article/20180903/PRINT/180909992/more-institutional-investors-putting-money-on-esg
[5] https://www.pimco.co.uk/en-gb/insights/blog/10-reasons-esg-investing-is-growing/

All of these concepts point to increased awareness or visibility of ESG concerns that ultimately drive investment decisions. This is positive because ESG analysis can assist in understanding how future trends could potentially influence certain industries or the economic landscape as a whole. Financial professionals, for instance, anticipate that ESG issues and climate change, in particular, will steadily but significantly alter the economic landscape in which companies operate and, according to a joint report by The Asset Management Working Group of the United Nations Environment Programme Finance Initiative and Mercer, "cause periodic sharp movements in asset prices."[6]

Investors are correlating investment performance with ESG which augments the importance of managing and analyzing ESG metrics of investments

Current Academic Research

A contemporary piece of academic research titled "Contracts with Benefits: The Implementation of Impact Investing"[7] focusing on optimal contracting to incorporate "social concerns into traditional profit ventures" was presented by Jessica S. Jeffers at the Private Equity Research Consortium (PERC) Symposium[8] in 2018. From a contract perspective, it observed the blending of "two goals at once: a financial goal as well as a social-benefit goal" (page 36)—which, indeed, complicates things although "some impact investors are willing to earn lower returns in exchange for impact" (page 5). I emphasize *some investors* because it seems that ESG or impact investing might be at odds with the highest-performing investment strategies, however, I believe this is only the case from a rather short-term investment viewpoint.

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[6] https://www.responsible-investor.com/images/uploads/Demystifying_Responsible_Investment_Performance.pdf
[7] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3159731
[8] http://www.kenaninstitute.unc.edu/index.php/event/10th-annual-private-equity-research-consortium-perc-symposium/

Climate of change

In this very real "*climate of change*" and the potential implications to way of life there will likely be an acceleration in our understanding of the correlation between returns and ESG goals. According to an article in the Harvard Law School Forum on Corporate Governance and Financial Regulation by Michael T. Cappucci of Harvard Management Company[9], "more than forty years' of academic and empirical evidence suggest that ESG integration in the investment process can lead to better risk-adjusted returns and long-term value creation. And the gold standard for sustainable investing is the full integration of ESG factors into the investment process." ESG goals could continue to be emphasized and further proven to be positively correlated with long-term investment goals which will lead to an accelerated emphasis on ESG across global business practices.

[9] https://corpgov.law.harvard.edu/2017/07/26/the-esg-integration-paradox/

What does it mean?

So, what does this mean for institutional investors? Private equity is still maturing in regard to best practices, standardization, and better metrics for more transparent and consistent investor reporting and analysis. In fact, even ESG ratings for the listed securities side of our portfolios are still evolving and performance experts struggle with coverage, a variety of data sources, as well as developing analysis[10] for current KPIs so we can conclude that the more opaque private capital markets will take longer. This means that any technology solutions and portfolio analysis we are using today must be flexible and adaptable enough to grow with this shifting landscape of PE reporting.

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Published during the onset of the global financial crisis and previously cited this paper, Bassen and Kovacs' article argues that "evaluation of ESG matters enables a thorough understanding of the risks and opportunities a company faces, allowing enhanced security selection and risk management."[2] I believe that as our understanding of how closely ESG is connected to our long-term investment returns grows, so will our desired data set grow and evolve for measuring ESG. This means that investing in versatile, adaptable technology and services is a smart decision for asset allocators who need solutions that will grow with their portfolio management objectives. ■

[10] https://www.pionline.com/article/20181015/PRINT/181019930/third-party-esg-ratings-evolving-for-investor-needs

Afterward by PFA Solutions

PFA Solutions is focused on providing strong capabilities to support ESG reporting and analytics and adapting to changes as our clients' business models evolve. We anticipate continued changes and are preparing for the future by understanding the data points, format, and importance of various ESG components. **Our goal is for our performance reporting solutions to enable seamless collection, management, and analytics of ESG data.** We look forward to continuing to build value-add solutions across the alternative investment industry to provide industry-leading technology solutions.

– Richard Change, Managing Partner @ PFA Solutions

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